1976

Taxation

Stephen R. Lohman

Follow this and additional works at: https://scholarship.law.edu/lawreview

Recommended Citation
Available at: https://scholarship.law.edu/lawreview/vol25/iss3/9

This Notes is brought to you for free and open access by CUA Law Scholarship Repository. It has been accepted for inclusion in Catholic University Law Review by an authorized editor of CUA Law Scholarship Repository. For more information, please contact edinger@law.edu.

The transfer of income-producing property to a Clifford trust has allowed the taxpayer in a high tax bracket to divert income and his federal tax liability to lower bracketed beneficiaries while retaining reversionary control over the property. The effectiveness of the device depends upon complete income shifting which, in the case of investment property, is accomplished simply by gift of the property to an independent trustee. Thereafter, income produced by that property is taxed either to the trust or to the beneficiaries. When business property which the taxpayer must occupy for his normal livelihood is involved, however, the device is effective only to the extent that the taxpayer can deduct, as a business expense, the rental payments made pursuant to a leaseback of the property from the trustee.

The gift-leaseback has become a relatively risky method of income-
splitting in the last decade, however, as courts have increasingly scrutinized the degree of independence granted to the trustee and have required that the gift-leaseback, as a whole, serve some ostensible “business purpose” before deduction of rental payments will be allowed under section 162(a)(3) of the Internal Revenue Code. This business purpose requirement essentially conflicts with the obvious purpose of most Clifford trusts and has discouraged the gift-leaseback of business property. In Perry v. United States, however, the United States Court of Appeals for the Fourth Circuit recently suggested that a showing of trustee independence at the time of leaseback as well as during the trust term, in conjunction with valid trust and lease instruments, may justify rental deductions under section 162(a)(3). Planners should be able to create the factual circumstances suggested by Perry and thereby decrease the risk of income-splitting by the gift-leaseback of rental property.

The taxpayers in Perry were two physicians who, in 1963, constructed their medical clinic on land owned in common. Their partnership was thereafter the sole occupant of the building. In 1968, each partner transferred his one-half interest to a corporate trustee, a bank, in favor of his children and retained a reversionary interest effective upon trust termination. Simultaneously, each taxpayer leased back the transferred interest at the Cary, Current Tax Problems in Sale, or Gift, and Lease-Back Transactions, N.Y.U. 9TH INST. ON FED. TAX. 959 (1951); Gold, Trust and Leaseback, 40 A.B.A.J. 714 (1954); Note, The Use of Business Property as Short-Term Trust Corpus, 19 VAND. L. REV. 811 (1966).

6. See, e.g., I.L. Van Zandt, 40 T.C. 824, 831 (1963), aff’d, 341 F.2d 440 (5th Cir.), cert. denied, 382 U.S. 814 (1965). One commentator has suggested that inconsistency in the case law has rendered the gift-leaseback nothing more than a gamble. H. Harris, supra note 2, § 145. Nevertheless, the gamble may be required when the tax-payer's major asset is business property.

7. INT. REV. CODE OF 1954, § 162 provides in part:
   (a) In General.
   There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

   (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.


9. 376 F. Supp. 15, 16 (E.D.N.C. 1974). Because so many of the gift-leaseback cases involve physicians, these trusts are often called “doctor trusts.” See Lemann, The “Doctor Trust”: Principles for Successful Planning that Emerge from Analysis of the Cases, 2 ESTATE PLANNING 2 (1974), which also provides the basic fact patterns and results of several related cases.
reasonable rental of $200 per month. The lease periods coincided with the duration of the trusts. During the 1969 tax year, the partnership paid the trustee the $4,800 rent required by the leases and deducted that amount from gross income. The Commissioner of Internal Revenue disallowed that deduction and assessed additional taxes. Upon payment of the deficiencies, the taxpayers brought refund suits in the United States District Court for the Eastern District of North Carolina.

The government admitted the validity of the Clifford trusts and the reasonableness of the rents but contended that the gift-leasebacks had no tax consequences because they were sham transactions serving no business purpose. The government argued that the voluntary creation of such arrangements could not result in necessary business expenses within the meaning of section 162(a)(3). The taxpayers, on the other hand, relied on a literal interpretation of section 162(a)(3). Following a valid gift of the building to an independent corporate trustee, the taxpayers argued, satisfaction of the rental obligations was a necessary condition to the continued occupancy of the premises. In granting the taxpayers' motion for summary judgment, the district court stressed the independence of the corporate trustee and the enforceable rental obligation assumed by the taxpayers. Presumably encouraged by remarkable success in recent gift-leaseback cases, the government appealed.

10. 376 F. Supp. at 16. Dr. Perry had created a 10-year trust while Dr. Medders had created a 14-year trust.
11. Id.
12. Id. at 18. The government's admissions merely focused the inquiry on the deductibility issue and did not significantly weaken or alter the government's main arguments.
13. The government argued alternatively that the reversionary interests constituted retained equity for which contributions were not deductible. Id. See notes 59-61 & accompanying text infra.
14. 376 F. Supp. at 18. The ostensible distinction between the government's and taxpayers' contentions, therefore, was at which point in time "necessary" should be determined: prior to the gift-leaseback as a whole, or subsequent to the gift but prior to the lease.
15. Id. at 16. Each party had moved for summary disposition following stipulation of the facts.
16. There appear to have been seven cases directly on point since 1968, all won by the government. While some of the cases represent examples of obvious taxpayer blunders, other cases underscore the necessity of careful drafting. Mathews v. Commissioner, 520 F.2d 323 (5th Cir. 1975); Wiles v. Commissioner, 491 F.2d 1406 (5th Cir. 1974), aff'd mem. 59 T.C. 289 (1972); Duffy v. Commissioner, 487 F.2d 282 (6th Cir. 1973); Audano v. Commissioner, 428 F.2d 251 (5th Cir. 1970); Chace v. United States, 422 F.2d 292 (5th Cir. 1970); Robert F. Zumstein, 32 CCH Tax Ct. Mem. 198 (1973); Sidney W. Penn, 51 T.C. 144 (1968). See Lemann, supra note 9, at 6.
The Fourth Circuit reversed after observing that the grantors had transferred previously owned property to trusts, had leased those interests back—thus creating rental obligations when none had previously existed—and had retained reversionary interests. Although state law had vested in the trustee "virtually every right, privilege and incident of ownership enjoyed by the grantor," the court found the bank's independence as trustee "illusory" since the original lease had irrevocably committed the entire corpus to the grantors on terms which the grantors had arranged prior to the actual creation of the trusts. The court concluded that the lack of trustee independence necessarily meant that the obligations to pay rent had not "resulted from a transaction with a real business purpose." Hence, such payments could not be deducted as ordinary and necessary business expenses under section 162(a)(3).

The court reached its conclusion by finding that the grantors had so controlled the entire arrangement that they, in effect, precluded the trustee from the exercise of fiduciary independence. This article will examine the basis of that finding and whether or not trustee independence should be the test for deductibility of rental payments following the leaseback of business property given to a bank in trust.

I. FACTORS AFFECTING DEDUCTIBILITY OF RENTAL PAYMENTS FOLLOWING THE GIFT-LEASEBACK

The use of trust devices for splitting income among family members seems to have gone unchallenged until the late 1930's, when the Commissioner of Internal Revenue began taxing "transferred" income to the grantor rather than to the trust or its beneficiaries. The first court challenge to the Commissioner's position appears to have been brought by a grantor who transferred securities to himself as trustee for his wife. In \textit{Helvering v. Clifford}, the Supreme Court found that "the short [five-year] duration of

\begin{itemize}
\item 18. 520 F.2d at 238.
\item 19. \textit{Id}.
\item 21. The ease with which the income tax laws could be circumvented by these and other devices had become well-recognized. \textit{See} \textit{Hearings Before the Joint Comm. on Tax Evasion and Avoidance}, 75th Cong., 1st Sess. (1937); Paul, \textit{The Background of the Revenue Act of 1937}, 5 U. Chi. L. REV. 41 (1937).
\end{itemize}
the trust, the fact that the wife was the beneficiary, and the retention of control over the corpus by [the grantor] all lead irresistibly to the conclusion that [the grantor] continued to be the owner for [tax] purposes..."\(^2\) The grantor, as owner of the securities, was therefore taxable on the income. Although the primary factor in the decision was the "dominion and control" retained by the grantor over the property, the Court failed to establish any ascertainable criteria for determining what degree of retained control constituted ownership for tax purposes.

The Treasury Department attempted to clarify the uncertainty generated by the *Clifford* decision with its promulgation of the Clifford Regulations in 1945.\(^24\) While *Clifford* had correlated the taxability of trust income with the degree of control over the property retained by the grantor, the regulations addressed the ancillary issue of trustee independence. Under relatively precise guidelines, trust income generally was taxable to the grantor if the corpus or income rights could revert to the grantor within 10 years of trust creation, if the beneficial ownership of the corpus was subject to the grantor's power of disposition, or if the corpus was subject to any exercise of discretion for the individual benefit of the grantor.\(^25\) Determination of trust validity for tax purposes thus became focused on the independent exercise of fiduciary responsibility. Congress enacted these regulations almost verbatim as sections 671 through 678 of the Internal Revenue Code of 1954.\(^26\)

While compliance with the regulations or their successor Code sections has assured the benefits of income-splitting to grantors of investment property, the additional requirement of deductibility under section 162(a)(3) has always faced grantors of business property. Nevertheless, in the first four cases in which the government moved against the gift-leaseback,\(^27\) the

---

23. 309 U.S. at 335.
25. Treas. Reg. 111, § 29.22(a)-21(b) (1945), T.D. 5488, 1946-1 CUM. BULL. 19. One case held that drawing the durational line at 10 years was unconstitutionally arbitrary and unreasonable and deprived taxpayers of property without a required hearing. Commissioner v. Clark, 202 F.2d 94 (7th Cir. 1953).
27. Brown v. Commissioner, 180 F.2d 926 (3d Cir.), cert. denied, 340 U.S. 814 (1950), rev'g 12 T.C. 1095 (1949); Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948), rev'g 8 T.C. 415 (1947); John T. Potter, 27 T.C. 200 (1956); Albert T. Felix, 21 T.C. 794 (1954). Following reversal of its first two decisions, the Tax Court seemed more willing to approve the *Potter* and *Felix* arrangements.
taxpayers prevailed on the ground that valid trusts and legally binding leases had been created. For example, in *Skemp v. Commissioner*,\(^{28}\) the grantor had created a 20-year nonreversionary trust of his office building and had leased the building back from the bank trustee for a 10-year term with a 10-year renewal option. The Seventh Circuit found that rental payments made pursuant to an enforceable lease obligation were indeed "ordinary and necessary" expenses "required to be made as a condition to the continued use or possession [of the premises], for purposes of trade or business . . . ."\(^{29}\) The government's arguments in these early cases paralleled the "dominion and control" argument which had succeeded in the *Clifford* attack upon trust validity. But upon findings of trust validity in accordance with the regulations or sections 671 through 678, the earlier courts concluded that rental payments made pursuant to valid leases were deductible.

The Tax Commissioner was not content to view the gift to trust and subsequent leaseback as separate transactions. In *Hall v. United States*,\(^{30}\) the Commissioner argued that "economic reality" should govern the tax consequences of the arrangement: the substance of the arrangement—apparently the income split—should determine the necessity, and hence the deductibility, of the rental payments.\(^{31}\) While the United States District Court for the Northern District of New York agreed with this argument, several significant "economic realities" created by the gift-leaseback were disregarded. Trust beneficiaries normally have available a panoply of contract and tort remedies against nonproductive trustees.\(^{32}\) The annual land tax bill, usually payable by the trustee as legal owner, is economically real. Inter vivos trust giving is also recognized for estate and gift tax purposes.\(^{33}\) Perhaps most important, the grantor-lessee's continued nonpayment of rent could result in a summons for summary possession dutifully filed by the fiduciary in the local landlord-tenant court. Nevertheless, the questionable technical accuracy of the economic reality argument is not its major strength. Rather, the argument impels a court to view the gift-leaseback from an overall, detached vantage point, from which the inconsis-

\(^{28}\) 168 F.2d 598 (7th Cir. 1948), reved 8 T.C. 415 (1947).
\(^{29}\) INT. REV. CODE OF 1954, § 162(a)(3). The partial text of that section is set out in note 7 supra.
\(^{31}\) Id. at 586-88.
tency between the motivation behind the gift-leaseback and any normal definition of deductibility is clearly observable.  

Although the economic reality argument prevailed in Hall, the Commissioner was apparently not convinced of its continued validity and took the next opportunity to bolster the attack against rental deductions. In Van Zandt v. Commissioner, the grantor had transferred his business property to himself as trustee, reserving the reversionary interest, and had leased it back for the 10-year trust duration. Dr. Van Zandt's position was strikingly similar to that of the original Clifford grantor except that he had satisfied the technical requirements of duration and trustee independence established by the Clifford provisions of the Code. Although the position was so tenuous that one commentator was able to explain the case only as "an attempt to test the outer limits" of deductibility, the case nevertheless allowed the Commissioner to expand his argument. Before the Tax Court, the government not only advanced the economic reality theory, but also argued that rental payments, made pursuant to a gift-leaseback lacking overall business purpose, were not necessary expenses within the meaning of section 162(a). Noting that the issue was only the deductibility of rent payments as distinct from the taxability of the trust, Judge Dawson agreed with both contentions: the gift-leaseback had neither economic reality nor business purposes.

34. In Commissioner v. Tellier, 383 U.S. 687 (1966), Justice Stewart, writing for a unanimous Court, characterized the "ordinary and necessary" requirements of deductibility: 

Our decisions have consistently construed the term "necessary" as imposing only the minimal requirement that the expense be "appropriate and helpful" for "the development of the [taxpayer's] business." . . . The principal function of the term "ordinary" in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures. . . .

Id. at 689. While the trust grantors' rental payments meet the "ordinary" requirement, the controversy stems from whether or not they are also "necessary." Under the view adopted in Hall, the taxpayers' gifts were not "necessary" since they were not helpful for the development of the business. But since the taxpayers were not trying to deduct the value of the gift, application of the "necessary" standard to the gift in trust would seem inappropriate. Moreover, the validity of a gift and its tax effects are not normally judged by such a standard. See Note, supra note 5, at 819.

35. 40 T.C. 824 (1963), aff'd, 341 F.2d 440 (5th Cir.), cert. denied, 382 U.S. 814 (1965).

36. 341 F.2d at 441.

37. Lemann, supra note 9, at 4. That author considered it "hard to imagine any set of facts more favorable to the Commissioner." Id.

38. 40 T.C. at 830-31. See note 34 supra.

39. Id. at 829-31.
On appeal, the Fifth Circuit closely examined the role of the trustee in this arrangement and concluded that this trustee was not independent since "[t]he whole principal amount of the trust was irrevocably committed to the possession of the grantor the moment the trust was created." The lack of trustee independence compelled the court to adopt the "overall" approach established as an incident of Hall. Viewing the gift-leaseback as a single transaction, the court concluded that the obligation to pay rent had not arisen as an ordinary and necessary incident of business since the arrangement had effected no ostensible business purpose.

The Fifth Circuit specifically indicated that Van Zandt was not a case of an independent trust, which would be accorded full tax effect, since trustees of independent trusts, unlike the trustee in this case, were "required to handle the affairs of the trust under the strict principles of a fiduciary in the management of the property." It was not clear, however, whether similar analysis could ever be applied to a bank trusteeship. Five months after the Fifth Circuit had affirmed Judge Dawson's Van Zandt opinion, he answered the question negatively.

In Alden B. Oakes, the grantor leased the entire trust corpus from the bank trustee two days after execution of the trust agreement which had conveyed the property to the trustee. Originally retaining a reversionary interest, the taxpayer had assigned that interest to his wife during the first of the three tax years in question. The Tax Court found that a bank as trustee created sufficient trust independence to warrant disregard of the lack of business purpose. Indeed, Judge Dawson believed that, "[w]here, as here, a grantor gives business property to a valid irrevocable trust over which he retains no control and then leases it back, it is not necessary for us to inquire as to whether there was a business reason for making the gift. Admittedly there was none." The court further asserted that the test of business necessity should be applied only to the circumstances existing after the gift in trust had occurred. Significantly, the government did not appeal, possibly because of the deference traditionally accorded corporate trustees, or perhaps because the government wished to preclude the Tax Court's reasoning from becoming appellate precedent. In any event, the govern-

---

40. 341 F.2d at 443. Such a commitment occurs upon execution of the lease agreement which, as a technical matter, must follow conveyance of the property into trust since the trustee must possess the fee before a leasehold interest can be carved out.
41. Id.
42. 44 T.C. 524 (1965).
43. Id. at 529-32.
44. Id. at 532.
ment's failure to appeal seemed to indicate that naming a bank as trustee would save a grantor-taxpayer from application of the *Van Zandt* rule.\(^4\)

II. Actual Trustee Independence: The Sine Qua Non of Deductibility

The procedural certainty flowing from the tax planner's recognition of the *Van Zandt-Oakes* distinction was relatively short-lived. In *Perry*, the Fourth Circuit pierced the shield of the *Oakes* bank trustee by finding *Van Zandt* applicable to the bank trusteeship. The court began its analysis by comparing the fact situation of *Van Zandt* to that of the *Perry* arrangement. In each instance, the court noted, grantors had owned the building prior to its conveyance in trust, free of any rent obligation. Following the gift-leasebacks, the occupancy and use of both premises continued unchanged while obligations had been created whose only apparent purpose was to divert tax liability from the grantors to their children. Because of the similar effects of the arrangements on the grantors, the court mechanically adhered to the result obtained in *Van Zandt*.\(^4\)

The *Van Zandt* court had been careful, however, to search for business purpose only after a finding that the trustee lacked independence. The lack of independence, of itself, did not render the rental payments nondeductible. The Fourth Circuit, on the other hand, truncated that approach by equating the "contemporaneous" leaseback with lack of business purpose. Upon finding the trustee's independence "illusory," the court immediately concluded "that the taxpayers' obligations to pay rent to the bank did not result from a transaction with a real business purpose."\(^4\)

The clear implication of this rationale is that trustee independence somehow indicates or imparts a business purpose to the arrangement sufficient to sustain rent deductions. This result reveals the fallacy of shortening the Fifth Circuit's approach. While some courts have suggested that an independent trustee is indicative of the legal validity of a transaction, no court has ever related trustee independence directly to the grantor's motivation in creating or funding the trust. Indeed, the primary function of trustee independence under these circumstances is not to cloak an otherwise personal transaction with business purpose; rather, it is to protect the beneficiary interests by assuring objective management of the trust property. The *Perry* court confused the subjective

---

\(^{45}\) In *Wiles v. Commissioner*, 59 T.C. 289, 300 (1972), *aff'd mem.*, 491 F.2d 1406 (5th Cir. 1974), the Tax Court applied this distinction. The grantor-trustee's retained control was sufficient to sustain the Commissioner only after the court had specifically noted that the grantor had failed to name a bank as trustee.

\(^{46}\) 520 F.2d at 238.

\(^{47}\) *Id.*
intention of the grantors with the objective performance of the fiduciary duties owed by the corporate, chartered trustee.

This confusion is the direct result of the interpretation given to the scope of the Code's Clifford provisions by the Perry court and by most courts which have passed on the rent deduction issue. The Senate report accompanying the 1954 Code indicated that the Clifford provisions were not intended to govern the deductibility of payments to trusts under transfer-leaseback arrangements. While no such language can be found in the House report, courts have uniformly construed the Senate report to mean that the statutory trustee independence standards governing the taxability of trusts as separate entities do not apply to the degree of trustee independence necessary to sustain rent deductions under gift-leasebacks. The Clifford provisions and their predecessor regulations had been intended to clarify the trustee independence standards first enumerated by Justice Douglas in Clifford, but courts have disregarded those statutory guidelines when business property rather than investment property provides the trust funding.

Nevertheless, the Fourth Circuit did recognize the factual difference between a grantor as trustee and a bank as trustee. The court consciously refrained from directly questioning the bank’s performance as trustee by observing that the amount of rental payments and other lease conditions had been arranged by the grantors and that the lease, so arranged, had conveyed the entire trust corpus to the grantors for the trust duration. Therefore, the court concluded that “[t]here was literally no area in which the broad powers vested in the bank as trustee could operate.” To the extent that the lease terms could be arranged unilaterally by the grantors, that assertion

48. S. REP. NO. 1622, 83d Cong., 2d Sess. 365 (1954). According to the Senate report, the Clifford provisions were to govern only the separate taxability of trusts and were to have “no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement.” Id.
50. See Perry v. United States, 520 F.2d 235, 237 n.2 (4th Cir. 1975), cert. denied, 96 S. Ct. 782 (1976); Sidney W. Penn, 51 T.C. 144, 150 (1973). However, an interpretation of the Senate’s intent as applying to sale-leasebacks would seem more consistent with the equitable concept of section 162(a)(3). Under that view, the Senate could have been providing the flexibility needed to distinguish between true sale-leasebacks and mere mortgages whose “rental payments” consisted partly of payments for principal which increased equity. Had the Senate sought merely to prohibit deductions for payments which increased a mortgagor’s equity, then the rent deductions under a true gift-leaseback, in which payments did not affect an owner’s equity, would be governed by the trustee independence standards of sections 671 through 678 and a literal reading of section 162(a)(3). For further development of this point, see Oliver, supra note 4, at 35-39.
51. See p. 638 supra.
52. See, e.g., Sidney W. Penn, 51 T.C. 144, 150 (1973).
53. 520 F.2d at 238.
would seem true; when the grantor names himself as trustee, the assertion is indisputable. But when a bank is involved, the court’s finding necessarily implies that the bank, as lessor, merely agreed with the grantors’ “pre-arranged” leases regardless of their impact on beneficiary interests which the bank, as trustee, is under a duty to protect.

The assertion in this context is difficult to reconcile with the proper functioning of a fiduciary since the traditional role of a fiduciary becomes convoluted under a gift-leaseback. Normal analysis of fiduciary performance focuses on trustee efforts to obtain maximum economic return on the trust property while maintaining a reasonable degree of safety. Under the gift-leaseback, however, not only is the receipt of rental payments relatively assured by the grantor’s desire to divert predictable income, but the grantor is also willing to pay, indeed desirous of paying, the highest rent possible without becoming vulnerable to a “grossly excessive” attack.54 For these reasons, the court’s difficulty in refraining from attacking trustee independence directly is understandable. But it is also clear that trustee independence alone provides a questionable measure for determining the deductibility of rent payments.

Having decided to follow Van Zandt regardless of the different trustee identities, the court distinguished Skemp on the same grounds which the Fifth Circuit had advanced in Van Zandt. First, Skemp had been decided on a bifurcated basis—the individual validities of the trust and rental obligation being determinative—while the Fourth Circuit preferred an overall approach requiring “real business purpose.”55 This distinction is consistent with the rationale of Van Zandt, since the taxpayer there could possibly have prevailed upon an adequate showing of business purpose. But the court’s abbreviated reasoning in Perry does not admit to a showing of business purpose even if the trustee lacked independence. The court gave no indication that business purpose would somehow become material were the trustee found to be independent. Thus, rather than focusing on the arrangement as a whole, the court simply shifted the emphasis from the individual elements of the gift-leaseback to the single issue of trustee inde-

54. The fact that rental payments for equipment worth $8,000 to $10,000 totaled $58,000 over five years (“grossly excessive”) was one factor in a Fifth Circuit decision that a trust-leaseback device was an economic nullity for tax purposes. Audano v. United States, 428 F.2d 251, 257-59 (5th Cir. 1970), rev’d 69-1 U.S. Tax. Cas. ¶ 9354 (N.D. Tex. 1969). While the Audano court construed excessive rentals as indicative of economic nullity, only that amount found to exceed fair rental value will likely be disallowed when both parties are business entities. See, e.g., Sparks Nuggett, Inc. v. Commissioner, 458 F.2d 631 (9th Cir. 1972), cert. denied, 410 U.S. 928 (1973).
55. 520 F.2d at 239.
pendence. The existence or nonexistence of business purpose was irrelevant to
the court's analysis and therefore provides a questionable basis for distinction.

The second manner in which Skemp was distinguished was based on the
*Van Zandt* court's statement that the grantor in Skemp had transferred more
property in trust than was subsequently leased back. While that assertion is
supported by neither the Tax Court nor the Seventh Circuit *Skemp* opinions,
the court quoted *Van Zandt* to the effect that a valid business purpose could
be discerned in conveying investment property—the remainder of the building
not physically occupied by the grantor—to the trustee “for management and
payment of income to beneficiaries, since the whole income did not come
from the grantor.” However, tax law never requires business purpose for
making a valid gift of investment property. It seems unusual that a court
would find business purpose where none is required and probably none
exists. Moreover, as mentioned above, any business purpose which may
have motivated this leaseback would not have affected the result, since lack
of trustee independence, not lack of business purpose, had been the critical
element.

The final basis for distinguishing Skemp was that the grantor in Skemp
had retained no reversionary interest. Although the court indicated that
the retention of such an interest was inconsistent with valid business purpose,
the basis for relating the reversionary interest to business purpose is unclear.
The court may have been responding to the government's argument that the
reversionary interest constitutes a “retained equity” for which payments are
not deductible under section 162(a)(3). The district court in Perry
responded to that contention by noting that the rental payments were made
only to assure the continued use of the property and not to enlarge the
grantors' share of ownership. While the Fourth Circuit disagreed, the basis
of the disagreement was not addressed in the appellate opinion. The
argument does have some merit, however. The future interest has ascertain-
able present value, and, as one commentator has pointed out, the present
value of the reversionary interest increases steadily during the trust term
until, at termination, the present value of the reversion equals the current

---

56. *Id.*, citing 341 F.2d at 442.
57. Both *Skemp* opinions indicate that Dr. Skemp had leased back the entire premises
under a 10-year lease with a 10-year renewal option, thus matching the 20-year trust
term. *See* 8 T.C. at 418; 168 F.2d at 599.
58. 520 F.2d at 239, quoting 341 F.2d at 442. The mere transfer of the managerial
burden for personal purposes would seem an equally implicit reason for such a convey-
ance.
59. 520 F.2d at 239.
60. The first successful use of this argument seems to have occurred in Hall v. United
States, 208 F. Supp. 584 (N.D.N.Y. 1962), in which the district court relied on it as an
alternative basis for disallowing the rent deduction. And the taxpayer in Alden B.
market value of the property. Although the rental payments do happen to coincide with an increase in the present value, neither the amount nor the fact of increase is contingent upon any tenant's rental payments. Nevertheless, although the Fourth Circuit did not rely on the retained equity theory, it appears likely that the government will continue to make this argument.

The Commissioner may also be able to fashion an argument from the court's observation that the instant arrangement provided relative certainty of the diversion of set amounts of income throughout the applicable periods. Rather than suggesting that a gambling atmosphere is more conducive to financial arrangements than minimization of risk, the court was perhaps suggesting that a complementary relationship existed between the grantors' certainty of income diversion and the independence exercisable by the trustee. This rationale is consistent with the court's original analysis of trustee independence, and indicates that lease terms might substantially influence a future court's determination of trustee independence.

In Perry, the original lease conveyed the leasehold interest at a fixed rental throughout the trust term. Thus, no future rent negotiations could occur and the trustee could exercise no discretion over new tenants or alternate uses of the property. Subsequent to the original lease, no "broad powers of management vested in the bank as trustee could operate." Notwithstanding the original lease terms, however, the bank as trustee in fact had assumed the role of lessor for the original lease and thus had performed its fiduciary duty to make the corpus productive. Any question in that context would concern fiduciary performance, not fiduciary independence. Of course, a trustee is able to exercise independence more frequently and

Oakes, 44 T.C. 524 (1965), was saved from disallowal after the court found that his assignment of the reversionary interest had terminated his equity. The Oakes court specifically noted, however, that a reversionary interest constituted an "equity" within the meaning of section 162(a)(3). 44 T.C. at 531. However, the more likely explanation of the "equity" language is that Congress meant to prohibit deduction of mortgagors' contributions to principal. See note 50 supra; 4A J. MERTENS, LAW OF FED. INCOME TAX § 25-108 (rev. ed. 1972). See also Rev. Rul. 25, 1955-1 CUM. BULL. 283.


62. 520 F.2d at 239. The court made this observation in distinguishing two cases advanced by the taxpayers: Brooke v. United States, 468 F.2d 1155 (9th Cir. 1972), and Brown v. Commissioner, 180 F.2d 926 (3d Cir.), cert. denied, 340 U.S. 814 (1950). Indeed, soon after Brown had been decided, one commentator warned that leasing back for the entire trust duration was unsafe since the trustee exercised so little independence both at the time of leaseback and subsequently. See Cary, supra note 5, at 974.

63. 520 F.2d at 238.

64. See RESTATEMENT (SECOND) OF TRUSTS § 181 (1959); G. BOGERT, TRUSTS AND TRUSTEES § 681 (2d ed. 1960); 2 A. SCOTT, TRUSTS § 181 (2d ed. 1959).
convincingly if the original lease term does not extend to the full trust term and the trustee's independence at future rent negotiations is not restricted. Moreover, negotiation of the original lease subsequent to trust creation would provide a further indication of trustee independence.

III. CONCLUSION

By extending the *Van Zandt* analysis to a situation for which it was not intended, the Fourth Circuit has assumed that individual grantors might preempt the state statutory powers given a fiduciary trustee. A result predicated on that assumption conflicts with the deference traditionally accorded the independence of a corporate fiduciary. The most disheartening aspect of the *Perry* result, however, is the injection of an unnecessary element of uncertainty into a tax planning atmosphere in which certainty had previously prevailed. Planners are no longer safe in relying on the independence of the corporate trustee but must now themselves create a situation, in form, to camouflage the obvious substance of the gift-leaseback. Specifically, the grantor must return to the bank a few days after the trust deed is executed, agree to a rental amount ideally based on appraisal, and sign the trustee's 1-year form lease after striking any renewal option language. Yearly thereafter, the taxpayer repeats the process of "negotiating" rent and executing a new lease agreement.

In the absence of ambiguous statutory language or congressional intent to the contrary, the court's focus on trustee independence which has satisfied the only applicable legislative requirements sharpens the wholly judicial distinction between investment and business property as vehicles for income-splitting through Clifford trusts. Nevertheless, attention by tax planners to the details surrounding the leaseback from the corporate trustee should insulate the grantor of business property from effective challenge.

*James D. Walker*

---

65. In Robert v. Zumstein, 32 CCH Tax Ct. Mem. 198 (1973), the Commissioner prevailed because the lease agreement gave the grantor-lessee the option to renew from year to year with rent set at the previous year's amount in the event of dispute. An even more egregious situation exists when the renewal options are included in a pretrust agreement. The Fifth Circuit has recently rendered the obvious result to that arrangement. See Mathews v. Commissioner, 520 F.2d 323 (5th Cir. 1975).

66. Although the *Oakes* lease was entered into two days after execution of the trust deed, the Tax Court relied on the inherent independence of the bank rather than the intervening period. The gap between trust creation and leaseback, however, would logically preclude the independence issue and focus the inquiry upon the fiduciary's performance. Indeed, the *Perry* court specifically relied on the "simultaneous" nature of the arrangement.

Historically, the fifth amendment's guarantee that an individual shall not face a criminal charge of committing "a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury . . . ." has been hailed as necessary to provide "a protective bulwark standing solidly between the ordinary citizen and an overzealous prosecutor." Despite this assertion, the practices of many public prosecutors have led several judges and commentators to conclude that the grand jury of today serves at the pleasure of the public prosecutor and no longer insulates the citizenry from prosecutorial abuse. The decision in Johnson v. Superior Court has lessened the potential for prosecutorial abuse by placing an affirmative duty on a district attorney to inform the grand jury of exculpatory evidence in the possession of the prosecution. Johnson appears to be the only decision of a state's highest tribunal which places such a duty on the prosecution in a grand jury proceeding—a stage in the criminal process which does not afford an accused many of the procedural guarantees provided in an adversary proceeding.

1. U.S. Const. amend. V.

2. United States v. Dionisio, 410 U.S. 1, 17 (1973). Courts have long recognized that the proper and historic role of the grand jury is to stand between an accused and indiscriminate federal prosecution. See, e.g., Stirone v. United States, 361 U.S. 212, 218 (1960); Hoffman v. United States, 341 U.S. 479, 485 (1951); Hale v. Henkel, 201 U.S. 43, 59 (1906); Ex parte Bain, 121 U.S. 1, 10-12 (1887); In re Tyler, 64 Cal. 434, 1 P. 884, 887 (1884).


4. 15 Cal. 3d 248, 539 P.2d 792, 124 Cal. Rptr. 32 (1975).


Rulings of the Supreme Court permit grand juries to consider evidence which would be
In Johnson, the petitioner sought a writ of prohibition to restrain the trial court from proceeding to trial upon his indictment. Prior to the charge contained in the indictment alleging violations of California drug laws, Johnson has been arrested on charges of selling and possessing dangerous drugs. At a pretrial conference on the earlier charge, Johnson was informed by a deputy district attorney that a local jail sentence rather than a harsher state prison term would be recommended if Johnson provided information about narcotic dealers. The probation and sentence hearing was continued and during this period petitioner was under pressure to either produce information or face a harsher sentence. Subsequently, Johnson agreed to sell dangerous drugs to two undercover agents through a Mr. Sherman. After Sherman made arrangements with the agents to transact the sale in their hotel room, Sherman and Johnson drove to the hotel in separate cars. Sherman went to the agents' room while Johnson remained outside. When the transaction was completed, Johnson and Sherman were arrested. The district attorney elected to seek prosecution by information and filed a complaint seeking a preliminary hearing. Johnson testified about his prior deal with the deputy district attorney and stated that his objective in participating in the transaction was to inform on all the parties involved. The magistrate did not find the requisite "sufficient cause" to hold Johnson for trial and dismissed the charges against him. The district attorney then inadmissible at trial. See, e.g., United States v. Calandra, 414 U.S. 338 (1974) (illegally seized evidence); Costello v. United States, 350 U.S. 359 (1956) (hearsay). California law recognizes the grand jury as a nonadjudicative proceeding. See, e.g., People v. Foster, 198 Cal. 112, 243 P. 667, 670 (1926) (no right to produce witnesses in one's own behalf); People v. Dale, 79 Cal. App. 2d 370, 179 P.2d 870, 873 (Ct. App. 1947) (no right to be represented by counsel).

6. See CAL. PEN. CODE § 999a (West 1970) (petition for writ of prohibition based upon the ground that the indictment was found to be without reasonable or probable cause). Johnson alleged that the district attorney's withholding of exculpatory evidence denied him due process and violated a statute requiring production of explanatory evidence. Id. § 939.7 (West 1970), quoted note 15 infra.

7. The indictment charged Johnson with conspiracy to commit and commission of the crime of transporting and selling amphetamine tablets in violation of CAL. HEALTH & SAF. CODE § 11352 (West 1975), and CAL. PEN. CODE § 182 (West 1970).

8. 15 Cal. 3d at 252, 539 P.2d at 794, 124 Cal. Rptr. at 34.

9. States are not bound by the fifth amendment's command that a grand jury indictment is the sole means by which an individual is charged with a serious crime. Hurtado v. California, 110 U.S. 516 (1884). California permits a prosecutor to seek prosecution "by information, after examination and commitment by a magistrate, or by indictment . . . ." CAL. CONST. art. 1, § 8. See CAL. PEN. CODE §§ 737-38 (West 1970).

10. 15 Cal. 3d at 252, 539 P.2d at 794-95, 124 Cal. Rptr. at 34-35. CAL. PEN. CODE § 871 (West 1970) provides in relevant part: "If, after hearing the proofs, it appears . . . that there is not sufficient cause to believe defendant guilty . . . the magistrate must order the defendant to be discharged . . . ."
sought to prosecute Johnson under the same charges by seeking a grand jury indictment. The district attorney did not reveal to the grand jury Johnson's exculpatory testimony before the magistrate. The grand jury subsequently returned an indictment.

The court of appeal issued a writ of prohibition on constitutional grounds, finding that the prosecutor knew that the transcript of the accused's prior testimony was available and admissible as evidence and that such evidence would be material and, if believed, would provide an explanation of Johnson's trip to the scene of the transaction as well as a basis for the belief "that he was an informer rather than Sherman's co-conspirator or accomplice." Omitting such evidence manipulated the grand jury to the point of depriving Johnson of his constitutional right to an independent grand jury finding of sufficient cause. While the court discussed the relevant statute as an example of the grand jury's "receptivity to evidence of innocence as well as guilt," the court's holding was clearly based on the ground that the nondisclosure of exculpatory evidence violated petitioner's right to due process.

The Supreme Court of California granted the government's petition for hearing, thus vacating and nullifying the opinion of the court of appeal. The

11. The California prosecutor is free to seek another prosecution for the same offense despite a magistrate's previous dismissal of the complaint. See, e.g., People v. Uhlemann, 9 Cal. 3d 662, 511 P.2d 609, 108 Cal. Rptr. 657 (1973) (dismissal of indictment is not a bar to another prosecution for same offense, either by seeking grand jury indictment or another information).


13. 38 Cal. App. 3d at 991, 113 Cal. Rptr. at 750.

14. Id. The court reasoned that in order for the grand jury to perform its central function as the independent adjudicator of probable cause, the prosecutor's duty must extend beyond "avoidance of suppression" and include an affirmative obligation to produce evidence which tends to negate guilt. The court did not cite any precedent which places such a due process obligation on a prosecutor. Instead it focused on rulings in other areas relating to prosecutorial behavior and the need for an independent and unbiased grand jury. Id. at 747-49.

15. CAL. PEN. CODE § 939.7 (West 1970), which formed the basis for the later opinion of the state supreme court, provides:

The grand jury is not required to hear evidence for the defendant, but it shall weigh all the evidence submitted to it, and when it has reason to believe that other evidence within its reach will explain away the charge, it shall order the evidence to be produced, and for that purpose may require the district attorney to issue process for the witnesses.

16. 38 Cal. App. 3d at 987, 113 Cal. Rptr. at 747.

17. Once a case is transferred to the supreme court for a hearing, the court of appeal's "opinion and decision are of no more effect . . . than if they had not been written." Knouse v. Nimocks, 8 Cal. 2d 482, 483-84, 66 P.2d 438, 438-39 (1937), cited in People v. Hopkins, 44 Cal. App. 3d 669, 678, 119 Cal. Rptr. 61, 66 (Ct. App. 1975).
court did not consider Johnson’s due process argument but instead chose to dispose of the case in his favor on statutory grounds. The court held that section 939.7 of the California Penal Code\(^\text{18}\) places an implied duty on a district attorney to inform the grand jury of the nature and existence of evidence reasonably tending to negate guilt.\(^\text{19}\) The court rejected the government’s argument that the plain meaning of the statute places the exclusive burden to order the disclosure of exculpatory evidence on the grand jury.\(^\text{20}\) The court reasoned that the grand jury’s capacity under section 939.7 to order evidence “within its reach [which] will explain away the charge” would be thwarted unless the district attorney brought exculpatory evidence to the attention of the grand jury.\(^\text{21}\) Otherwise, “the [grand] jury is unlikely to learn of it” and compel its production pursuant to the statute.\(^\text{22}\)

Justice Mosk, joined by Chief Justice Wright, issued a lengthy concurring opinion which termed the majority holding “a mere analgesic to ease the procedural pain” when there is a “need for substantive corrective surgery.”\(^\text{23}\) The surgery favored by

18. CAL. PEN. CODE § 939.7 (West 1970), quoted note 15 supra.
19. 15 Cal. 3d at 255, 539 P.2d at 796, 124 Cal. Rptr. at 36.
20. The government, after discussing authorities which interpreted section 939.7 as being applicable to the duties of the grand jury, argued that the statute does not delineate any duty, expressly or impliedly, on the part of the district attorney to submit to the grand jury anything more than a prima facie case unless, the grand jury having reason to believe, on its own motion, that exculpatory evidence exists, the district attorney is ordered by the grand jury to produce such evidence.
21. 15 Cal. 3d at 254, 539 P.2d at 796, 124 Cal. Rptr. at 37.
22. Id. at 255, 539 P.2d at 796, 124 Cal. Rptr. at 37.
23. Id., 539 P.2d at 797, 124 Cal. Rptr. at 37. It should be noted that Justice Mosk’s opinion relates solely to an indicting grand jury which determines whether there is probable cause that a specific suspect committed an offense. It does not challenge the “valuable and productive role” of an investigating grand jury which does not immediately focus on a particular individual, but rather uses its subpoena power to investigate whether a crime has been committed, usually in the areas of government corruption and organized crime. See 15 Cal. 3d at 256 n.1, 539 P.2d at 797 n.1, 124 Cal. Rptr. at 37 n.1. For a discussion of the investigatory and indictment functions of a grand jury, see Note, American Grand Jury: Investigatory and Indictment Powers, 22 CLEV. ST. L. REV. 136 (1973).
Justice Mosk is a rule which permits "every indicted defendant a post-indictment preliminary hearing as a matter of right."24 Such a rule, according to Justice Mosk, is needed to counter the existing grand jury proceeding which raises "the spectre of the Star Chamber" and denies indicted persons equal protection and due process of law.25

I. ROLE OF THE PUBLIC PROSECUTOR

*Johnson* can be expected to affect significantly the behavior of a prosecutor at the pretrial stage of the criminal process because it works against the government's control of the evidence submitted to the grand jury. The grand jury is greatly dependent upon the prosecutor for information, presentation of evidence, and advice on legal and evidentiary problems.26 Many jurisdictions permit the prosecution to appear before the grand jury for the purpose of advising it on matters pertaining to law and to its duties,27 but

24. 15 Cal. 3d at 256, 539 P.2d at 797, 124 Cal. Rptr. at 37.
25. Id. at 257, 262-67, 539 P.2d at 797, 801-05, 124 Cal. Rptr. at 37-38, 41-45. Justice Mosk outlined procedural guarantees afforded an accused faced with prosecution by information: preliminary hearing before a magistrate, representation by counsel, confrontation and cross-examination of witnesses, and the opportunity to appear and to present evidence. In contrast, he pointed out that the indictment process is characterized by "its deliberate omission of even minimal safeguards": no right of an accused to appear, no right to have counsel present, no right to confront and cross-examine witnesses. Id. at 257, 539 P.2d at 797, 124 Cal. Rptr. at 37. A constitutional right to a postindictment hearing providing procedural safeguards would remedy such a bald disparity. Id. at 270, 539 P.2d at 806-07, 124 Cal. Rptr. at 46-47. For a discussion of the potential significance of the concurring opinion, see note 65 infra.
26. The grand jurors "look to the prosecutor as 'their' lawyer, whose very decision to accuse imparts momentum to the accusation." 113 Cal. Rptr. at 748, citing People v. Superior Court, 38 Cal. App. 3d 966, 113 Cal. Rptr. 732 ( Ct. App. 1974). See also People v. Sears, 49 Ill. 2d 14, 273 N.E.2d 380 (1971) (proper channel for presenting information to the grand jury is the state attorney). Both of the proposed Grand Jury Reform Acts of 1975 would permit a federal grand jury to request the appointment of a special attorney in lieu of a government attorney to assist the grand jury in an independent investigation and sign any indictment. H.R. 2986, 94th Cong., 1st Sess. §§ 4(a), 4(b) (1975); H.R. 6006, 94th Cong., 1st Sess. §§ 4(a), 4(b) (1975).
27. See, e.g., CAL. PEN. CODE § 935 (West 1970) (prosecutor "may at all times appear before the grand jury for the purpose of giving information or advice relative to any matter cognizable by the grand jury . . . "); FLA. STAT. ANN. § 905.19 (Supp. 1975) (prosecution shall attend session of grand jury and give legal advice about any matter cognizable by jury); WIS. STAT. ANN. § 255.15 (1971) (duty of a district attorney to give grand jury advice on any legal matter). But see N.C. GEN. STAT. § 15A-624 (1975), which declares the presiding judge to be the legal advisor of the grand jury. North Carolina common law prevented the state solicitor from going into the grand jury room during sessions of the grand jury, see State v. Crowder, 193 N.C. 130, 136 S.E. 337 (1927), but more recently it has been held that the solicitor's presence in the grand jury room at a time when the jury is neither voting nor deliberating is insufficient by itself to invalidate a subsequent indictment. See State v. Colson, 262 N.C. 506, 138 S.E.2d 121 (1964).
some jurisdictions prevent the prosecutor from appearing before the grand jury when it is deliberating and voting. The significant power of the prosecutor to determine the depth and direction of evidence ordered by the grand jury is recognized in the American Bar Association recommendation that a prosecutor should disclose exculpatory evidence in his possession during the grand jury inquiry.

Although it appears that Johnson is the only authority for quashing an indictment on the ground of nondisclosure of exculpatory evidence, there are isolated holdings which suggest support for prosecutorial disclosure of facts favorable to the accused. In one case, People v. Dumas, petitioner, charged in an information with murder, was committed by a magistrate following a hearing on his mental condition. A district attorney pursued and obtained an indictment. Petitioner moved to examine the grand jury minutes to see whether a letter written to the grand jury concerning his commitment was thoroughly explained. While the case can be distinguished from Johnson on two points—it involved evidence mailed directly to the grand jury, and Dumas' motion was to examine the grand jury minutes rather than a motion to quash the indictment—the New York trial court held that a prosecutor has the responsibility to explain the legal ramifications of the commitment. The test applied by the court was whether the district attorney failed to disclose information which might affect "the result." In a later Oklahoma case, Stone v. Hope, the charge by information against petitioner for possession of marijuana was dismissed by the magistrate at a


29. The ABA recommendation states: "The prosecution should disclose to the grand jury any evidence which he knows will tend to negate guilt." ABA PROJECT ON STANDARDS RELATING TO THE ADMINISTRATION OF CRIMINAL JUSTICE ¶ 3.5(b) (relations with grand jury) (1975). For a more general guideline on prosecutorial fairness, see ABA CODE OF PROFESSIONAL RESPONSIBILITY, Disciplinary Rule 7-103 (1972).


31. The court, without citation to authority, apparently accepted the defendant's argument that "the District Attorney's obligation would also seem to be to disclose 'favorable' evidence to a Grand Jury as to a trial Jury." Id. at 932, 274 N.Y.S.2d at 770. Although this obligation was met here because the evidence was known to defense counsel who communicated it to the Grand Jury in a letter, the court granted the motion to examine so that defendant could determine whether the prosecution had met its duty to explain the evidence favorable to the defendant. Id. at 932-33, 274 N.Y.S.2d at 770-71.

preliminary hearing. The district attorney then persuaded a grand jury to return an indictment charging the same offense. The Oklahoma Court of Criminal Appeals held that the previous dismissal of a complaint must be disclosed to a grand jury considering the same charge. The court justified such prosecutorial disclosure by recognizing the importance of a magistrate's dismissal under Oklahoma law.\textsuperscript{33}

A prosecutor's failure to disclose the hearsay nature of the evidence presented to a grand jury may result in the dismissal of an indictment. The United States Court of Appeals for the Second Circuit has ruled that a prosecutor's sole reliance on hearsay evidence when firsthand testimony was available, coupled with his failure to inform the grand jury of the hearsay nature of the testimony, required dismissal of the resulting indictment.\textsuperscript{34} In \textit{United States v. Estepa},\textsuperscript{35} the sole witness was a policeman whose knowledge of the defendant's activities was "extremely limited."\textsuperscript{36} The witness spoke to the grand jury at length and the prosecutor "did nothing to alert the grand jury to any limitations on [the witness'] knowledge."\textsuperscript{37} An undercover patrolman, "the only person . . . who was in a position to inform the grand jury of just what occurred up to the point of the arrest,"\textsuperscript{38} was not called to testify. In dismissing the indictment, the court stated that "the grand jury must not be 'misled into thinking it is getting eye-witness testimony . . . whereas it is actually being given an account whose hearsay nature is concealed . . . .'"\textsuperscript{39} The rule in \textit{Estepa} recognizes that grand jurors often cannot be expected to know of the hearsay character of testimony unless the prosecutor informs them of that character. A grand jury informed of the hearsay character of the evidence would be less persuaded to find probable cause than if such a disclosure were not made. Thus it can be argued that the rule, in effect, places an affirmative duty on the prosecution to disclose facts beneficial to the accused's side of the case. However, the Second Circuit's rule appears not to be followed by other

\textsuperscript{33} Id. at 619-20. Under Oklahoma law, a magistrate's ruling on the sufficiency of the evidence is "final and binding" on other determinations of sufficient cause unless the prosecution presents additional evidence to the subsequent adjudicator of sufficient cause. \textit{Id.} at 619. For a discussion of \textit{Hope} and an argument in favor of applying its rule to subsequent decisions of the California Supreme Court, see pp. 662-63 \textit{infra}.

\textsuperscript{34} United States v. Estepa, 471 F.2d 1132 (2d Cir. 1972).

\textsuperscript{35} \textit{Id.}

\textsuperscript{36} Id. at 1134.

\textsuperscript{37} \textit{Id.} at 1134-35.

\textsuperscript{38} \textit{Id.} at 1134. The court was told that the undercover patrolman "was in the field doing other work that day" and that there were no reasons why there could not have been a short postponement for his presentation. \textit{Id.}

\textsuperscript{39} \textit{Id.} at 1136, \textit{quoting} United States v. Leibowitz, 420 F.2d 39, 42 (2d Cir. 1969).
circuits\textsuperscript{40} and, in light of United States v. Calandra,\textsuperscript{41} would possibly be disapproved if directly considered by the Supreme Court. In Calandra, the Supreme Court ignored Estepa and steadfastly reaffirmed the broad rule of Costello v. United States\textsuperscript{42} that there is no constitutional provision prescribing the kind of evidence upon which grand jurors must act.\textsuperscript{43}

The absence of a duty upon the prosecution to disclose exculpatory evidence to the grand jury in most jurisdictions is in sharp contrast to the prosecution's duty to disclose certain information at trial. The Supreme Court has held that "the suppression by the prosecution of evidence favorable to an accused upon request violates due process when the evidence is material either to guilt or to punishment, irrespective of the good faith or bad faith of the prosecution."\textsuperscript{44} Further expansion of a federal defendant's right to discover the government's case against him is provided by the Federal Rules of Criminal Procedure. Pursuant to Rule 16(c), a defendant is permitted, upon request, to have access to any documents, photographs, or other tangible objects which are material to the defense or are intended to be used by the prosecution as evidence at the trial.\textsuperscript{45} Under the Jencks Act,\textsuperscript{46} a defendant has the right for impeachment purposes to compel the prosecutor to produce any statements by government witnesses made prior to trial which relate to the subject matter of the witness' testimony.\textsuperscript{47} Failure of the government to produce such statements will force the trial judge to strike the witness' testimony from the record or to declare a mistrial when required in "the interests of justice."\textsuperscript{48} In 1970, Congress enacted an important amendment to the Jencks Act which placed grand jury testimony within the

\begin{itemize}
\item \textsuperscript{40} See, e.g., United States v. Powers, 482 F.2d 941, 943 (8th Cir. 1973), cert. denied, 415 U.S. 923 (1974); United States v. Cruz, 478 F.2d 408 (5th Cir.), cert. denied, 414 U.S. 910 (1973) (Second Circuit's rule "serves simply as a supervisory guideline to be employed by courts within their sound discretion ... [and has] never been considered, even by that circuit, as a constitutional requirement." 478 F.2d at 411).
\item \textsuperscript{41} 414 U.S. 338 (1974).
\item \textsuperscript{42} 350 U.S. 359 (1956).
\item \textsuperscript{43} In affirming the rule in Costello, the Court stated:
\[\text{T]he validity of an indictment is not affected by the character of the evidence considered. Thus, an indictment valid on its face is not subject to challenge on the ground that the grand jury acted on the basis of inadequate or incompetent evidence} \dotsc\]
\item \textsuperscript{44} Brady v. Maryland, 373 U.S. 83, 87 (1963).
\item \textsuperscript{45} Internal reports, memoranda and other materials made by the government in connection with the investigation or prosecution of the case are not subject to discovery. FED. R. CRIM. P. 16(a)(2).
\item \textsuperscript{46} 18 U.S.C. § 3500 (1970).
\item \textsuperscript{47} Id. § 3500(b).
\item \textsuperscript{48} Id. § 3500(d).
\end{itemize}
definition of "statements" subject to discovery under the Act. Thus, a government witness' testimony before a grand jury must be disclosed to a defendant at trial upon request if that witness is called upon to testify by the government. A defendant would then have access to grand jury testimony and therefore a better view of the propriety or impropriety of the grand jury inquiry. Prosecutors can be expected to rely upon Costello and Calandra for the purpose of avoiding the Jencks Act disclosure requirement by securing an indictment through the use of hearsay testimony and then calling upon non-grand jury witnesses to give firsthand testimony at trial. Disclosure of federal grand jury minutes for purposes other than impeachment rests within the discretion of the court.

In California, "criminal discovery has been opened up to an unprecedented extent." The California Supreme Court has ruled that there are instances in which the prosecution must disclose favorable material evidence despite the defendant's failure to request it. At trial, a defendant is entitled to obtain government witness' statements made to law enforcement officers, a transcript of the testimony before a grand jury inquiry, and the names and addresses of government witnesses. Even after Johnson, it is

49. Id. § 3500(e)(3) (1970) provides that the term "statement" as used for purposes of identifying the types of discoverable statements means "a statement, however taken or recorded, or a transcription thereof, if any, made by said witness to a grand jury."

50. A challenge to this procedure on the ground that it negates the purpose of section 3500(e)(3) was rejected in United States v. Cruz, 478 F.2d 408, 411 (5th Cir.), cert. denied, 414 U.S. 910 (1973) (government not required to develop potential Jencks Act statements for defendant).


53. See, e.g., In re Ferguson, 5 Cal. 3d 525, 532, 487 P.2d 1234, 1239, 96 Cal. Rptr. 594, 599 (1971) ("[T]o condition the duty to disclose upon request would provide a trap for the unwary and place substantial additional burdens on our busy trial courts.") Id.


56. See, e.g., People v. Cooper, 53 Cal. 2d 755, 349 P.2d 964, 3 Cal. Rptr. 148 (1960). California pretrial discovery does not rest on constitutional grounds, but is a means by which the court promotes "the orderly ascertainment of truth." See generally Jones v. Superior Court, 58 Cal. 2d 56, 372 P.2d 919, 22 Cal. Rptr. 879 (1962).
readily apparent that there remains a wide gap between the disclosure obligation placed on a prosecutor before the grand jury and the disclosure required at trial.

II. CONSTITUTIONAL CHALLENGE TO GRAND JURY PROCEEDING

Justice Mosk's constitutional challenge to the grand jury's indicting function is a reaction to the fact that numerous procedural rights are afforded to an accused faced with prosecution by information which are not afforded to the suspect of a grand jury inquiry. Since the Supreme Court's decision in *Hurtado v. California*, states have not been precluded from prosecuting by using the information procedure. In *Hurtado*, the Court held that the fifth amendment's guarantee that an individual shall not face a charge of committing a serious crime without the return of a grand jury indictment applies solely to federal prosecutions. As long as a state's prosecution by information guards the substantial interest of the accused, the due process clause of the fourteenth amendment does not require a grand jury indictment. Normally, such safeguards are abundantly provided when there is prosecution by information. In California, an accused charged with an information is entitled to a preliminary hearing before a magistrate, representation by counsel, cross-examination of adverse witnesses, and a presentation of evidence tending to rebut allegations of sufficient cause. On the other hand, as one noted commentator concludes, "the grand jury continues as a secret, ex parte inquiry guided by a predisposed prosecutor. The accused is denied an opportunity to confront his accusers, to cross-examine them, or to have the assistance of counsel."

Significantly, Justice Mosk's opinion may be acceptable to a majority of the present members of the California Supreme Court. Nevertheless,

---

57. 15 Cal. 3d at 255, 539 P.2d at 796, 124 Cal. Rptr. at 37 (Mosk, J., concurring).
58. 110 U.S. 516 (1884).
59. Id. at 538.
60. CAL. PEN. CODE § 858 (West 1970).
61. Id.
65. Justice Tobriner, in concurring with the majority holding, indicated his sympathy with Justice Mosk's discussion of "the serious constitutional questions" raised by the grand jury indictment, but withheld opinion on the merits of the constitutional claims.
despite the sharp contrast in safeguards afforded by the two procedures, California courts have steadfastly refused to hold such a disparity a violation of due process and equal protection of the law.\footnote{66}

The concurring opinion of Justice Mosk relied upon Coleman v. Alabama\footnote{67} and other decisions of the United States Supreme Court which provide for procedural guarantees at noncriminal disciplinary proceedings.\footnote{68} In Coleman, a preliminary hearing to determine whether there was sufficient evidence to bring an accused before a grand jury was deemed a “critical stage” of the criminal process, which under the sixth amendment compels states to provide the assistance of counsel. The Court ruled that a defendant’s potential harm of being indicted and facing trial warranted the presence of counsel at a preliminary hearing in which counsel may “expose fatal weaknesses in the State’s case” through cross-examination and “more effectively discover the case the State has against his client. . . .”\footnote{69} The Court did not mention the effect of the rule on a grand jury proceeding. The question has been posed that if the preliminary hearing in Coleman is a critical stage, “how can this be reconciled with the fact that the Constitution itself does not permit the assistance of counsel at the decidedly more ‘critical’ grand jury inquiry?”\footnote{70} Recent Supreme Court rulings extending procedural guarantees to individuals facing noncriminal or disciplinary proceedings suggest that a grand jury proceeding which may eventually lead to one’s incarceration should afford similar procedural rights.\footnote{71}
The protections established in *Coleman* and other procedural guarantees provided at a preliminary hearing may be avoided when a prosecutor elects to seek a finding of probable cause before a grand jury rather than a magistrate. A majority of jurisdictions allow district attorneys to avoid the unpleasantness of having their case discovered and facing defense counsel by permitting prosecution through the secret indicting process. In *People v. Uhlemann*, the California Supreme Court held that a prosecutor's failure to prove a finding of sufficient cause at the preliminary hearing does not bar his later success with the grand jury despite the grand jury's consideration of uncontradicted testimony of government witnesses who had been totally discredited at the preliminary hearing. Under these circumstances and those in *Johnson* in which it appeared "obvious that the district attorney was determined to initiate this prosecution in a forum that would preclude petitioner from testifying in his own behalf," a defendant would desire a post-indictment hearing on the issue of probable cause. However, authorities almost uniformly hold that an accused cannot demand a preliminary hearing after indictment since the indictment makes conclusive the existence of probable cause to hold the accused for trial. Oklahoma and Michigan run counter to the general rule. In *People v. Duncan*, the Supreme Court of Michigan, while noting that the disparity of procedural rights at the two proceedings might raise serious questions of equal protection and due process, stopped short of providing a postindictment hearing on constitutional grounds. Instead, the court rested on its "inherent power" to grant a post-indictment preliminary hearing as a matter of criminal procedure.

---


72. For a list of state statutes which permit the prosecution to elect between the filing of an information or indictment, see Dash, *supra* note 64, at 812 n.24.

73. 9 Cal. 3d 662, 511 P.2d 609, 108 Cal. Rptr. 657 (1973). *Johnson* condoned the practice of forum shopping by citing *Uhlemann* with approval. 15 Cal. 3d at 255, 539 P.2d at 796, 124 Cal. Rptr. at 36 (district attorney may continue to prosecute by seeking another indictment or by filing another complaint).

74. 15 Cal. 3d at 268, 539 P.2d at 805, 124 Cal. Rptr. at 45 (Mosk, J., concurring).


77. 388 Mich. 489, 201 N.W.2d 629 (1972).

78. *Id.* at 502, 201 N.W.2d at 635. The court reasoned that although the grand jury has the advantages of secrecy and the power to subpoena witnesses, in modern practice its effective use appears to be limited due to the grand jury's heavy reliance on the prosecutor for legal interpretations. *Id.* at 501, 201 N.W.2d at 634.
III. Johnson: Radical Response or Stopgap Approach?

Through statutory construction, the California Supreme Court has made mandatory the grand jury disclosure recommendation of the American Bar Association by placing a new procedural burden on a prosecutor seeking an indictment.\(^7\)\(^9\) To successfully quash an indictment returned in violation of Johnson, a defendant must show that during the grand jury inquiry there was evidence known to the prosecution and concealed from the grand jury which, if revealed to the grand jury, would reasonably tend to negate the guilt of the accused.\(^8\)\(^0\) The court used section 939.7 of the California Penal Code as its vehicle for increasing the independence of the grand jury and expanding the prosecutor's prima facie case for a finding of probable cause. The court sought to protect the accused and, in considering section 939.7, departed from its stated principles of statutory interpretation.\(^8\)\(^1\) While the court avoided the constitutional issues raised by the court of appeal and the concurring opinion of Justice Mosk, it still managed to provide an accused with some additional protection from prosecutorial abuse. Johnson emphasizes the difference between the district attorney's duty at trial, "where the adversary system operates" to compel the disclosure of substantial material evidence favorable to the defendant,\(^8\)\(^2\) and the ex parte grand jury proceeding. The grand jury's power under section 939.7 to order the production of exculpatory evidence "within its reach" would be illusory unless the grand jury is informed of such evidence. Thus the protection afforded by Johnson fits into a pattern of

---

79. Legislation pending before Congress would also mandate the ABA recommendation by requiring the district court before which a grand jury is impaneled to dismiss any indictment if it finds that the federal prosecutor "has not presented to the grand jury all exculpatory evidence in his possession." H.R. 6006, 94th Cong., 1st Sess., § 7(3) (1975); H.R. 2986, 94th Cong., 1st Sess., § 5(3) (1975).

80. The Criminal Division of California's Office of the Attorney General interprets Johnson as imposing a prosecutorial duty of disclosure of exculpatory evidence, but not a duty of seeking out, producing, or presenting such evidence, unless the grand jury requests that such evidence be produced after disclosure of its existence and nature by the prosecutor. Memorandum from Jack R. Winkler, Chief Assistant Attorney General for California, Criminal Division, to all California District Attorneys, Sep. 24, 1975.


82. 15 Cal. 3d at 255, 539 P.2d at 796, 124 Cal. Rptr. at 36.
judicial and statutory expansion of an accused's right to ample discovery of the government's case, access to grand jury minutes, and in California, an indictment not based solely on hearsay testimony. Johnson seems to be a logical extension of the Second Circuit's ruling in Estepa which prevents the prosecutor from misleading the grand jury by not disclosing the hearsay nature of the grand jury testimony. In both Estepa and Johnson, some disclosure on behalf of the accused was necessary to negate the unchallenged presentation to the grand jury.

Nevertheless, while Johnson provides a new measure of protection, the points raised by Justice Mosk as to the sufficiency of the majority opinion remain unanswered. Since the Court's decision in Hurtado, an increasing number of states, including California, have allowed their prosecutors to elect between prosecuting by information or indictment. The disparity in the degree of procedural rights afforded at each proceeding was ignored by the majority and emphasized by Justice Mosk. Such a disparity, particularly after Coleman, raises questions about whether measures adopted by the majority adequately protect an accused from prosecutorial abuse.

First, an accused must depend upon a prosecutor's perspective of what information contained in the preparation of a state's case is exculpatory. Factual disputes will arise over what evidence was in the possession of the prosecutor, whether that evidence was exculpatory, and the means by which such evidence was disclosed to the grand jury. Such debates between those arguing the Johnson rule and those distinguishing Johnson on its facts is well illustrated by Fasanaro v. Superior Court, the first post-Johnson case.

83. See notes 44, 45, 53, 54, 56 & accompanying text supra.
84. See notes 49, 55 & accompanying text supra.
85. See CAL. PEN. CODE § 939.6(b) (West 1970).
86. See notes 58, 59 & accompanying text supra.
87. Civil No. 36843 (Cal. Sup. Ct., Oct. 30, 1975). In Fasanaro, the prosecutor initially failed to have a 12-member grand jury return an indictment charging the accused with bribery and conspiracy. The grand jury was reconvened with two additional members and instructed not to consider any of the evidence submitted at the first proceeding. The prosecution proceeded to present its case but did not recall two witnesses alleged by Fasanaro to have given exculpatory testimony at the first proceeding. An indictment was returned. Fasanaro contended that not recalling the witnesses or informing the grand jury of their prior testimony violated the Johnson rule. See Petitioner's Brief in Reply to Supplemental Opposition to Petition for Writ of Prohibition at 22, Fasanaro v. Superior Court, Civil No. 36843 (Cal. Sup. Ct., Oct. 30, 1975). The government disputed the exculpatory nature of the previous testimony and noted that the original 12 members had the right to recall the two witnesses. Johnson was further distinguished by the government on the grounds that Fasanaro was permitted to voluntarily appear and explain "anything which he would like to convey to the grand jury." Respondent's Supplemental Brief in Opposition to Petitions for Writs of Prohibition at 9, Fasanaro v. Superior Court, Civil No. 36843 (Cal. Sup. Ct., Oct. 30, 1975). Such an appearance, argued the government, did not render the grand jury's right to receive
involving the prosecutor's duty of disclosure. Second, the majority holding does not provide a mechanism with which an unknowing subject of a grand jury proceeding can reveal exculpatory evidence in his possession. The ruling only applies to evidence in the possession of the district attorney. In situations in which the prosecution initiates prosecution by indictment without a previous preliminary hearing on the same charge, it is unlikely that the prosecutor would be aware of exculpatory material which may be disclosed by the accused. Third, the majority opinion reaffirmed the prosecutor's right to engage in forum shopping by citing *Uhlemann* with approval. Thus the court recognized the right of the prosecutor to shop for a closed forum after an earlier effort to prosecute on the same charge was dismissed by a magistrate at an open forum. This practice may be "unnecessarily burdensome . . . and may constitute harassment of an accused." For the court to advance from the protection announced in *Johnson*, it should consider Justice Mosk's arguments against the constitutionality of California's means of finding sufficient cause. Two remedies that might be considered are to limit the prosecutor's practice of forum shopping and to regard a grand jury proceeding as a critical stage of the criminal process.

### A. Limitation of Forum Shopping

A prosecutor may render meaningless the importance and judicial nature of the preliminary hearing as recognized in *Coleman* by shopping for a forum in which the strengths of the accused's defense and the weaknesses of the state's case may never be fully disclosed. A more equitable approach would be to follow the rule in *Stone v. Hope* in which an indictment was returned after the information charging the same offense had been dismissed at a preliminary hearing. *Hope* recognized that in Oklahoma a magis-

---

*See id. at 8-9. The supreme court remanded the case to the court of appeal which had rendered its denial of petitioner's writ prior to the supreme court's ruling in *Johnson*. Preliminary arguments before the court of appeal were scheduled on January 15, 1976. Telephone interview with Jean M. Bordon, Deputy Attorney General of California, in Washington, D.C., December 17, 1975.*

*88. See note 73 & accompanying text supra.*


*90. "The primary reason the prosecutor engages in such a strategy is to prevent the defense from gaining any discovery of his case. Before the grand jury he can secretly obtain the assessment of laymen of the strength of his case without providing any advantage to the defendant." *Dash, supra* note 64, at 813 n.26. See Graham & Letwin, Preliminary Hearing in Los Angeles: Some Field Findings and Legal-Policy Observations, 18 U.C.L.A. L. Rev. 635, 735 (1971); Comment, The Preliminary Hearing Versus the Grand Jury Indictment: "Wasteful Nonsense of Criminal Jurisprudence" Revisited, 26 U. Fla. L. Rev. 825 (1974).*

*91. See notes 32, 33 & accompanying text supra.*
trate's ruling on the issue of sufficient cause is "final and binding" on other magistrates or grand juries in the absence of additional evidence not presented and unavailable at the preliminary hearing. In the absence of such additional evidence, a returned indictment would be dismissed. By adopting the rule in Hope, the controlling points of Coleman and the due process rights of an accused at a preliminary hearing would be given greater weight at a grand jury inquiry held after an earlier dismissal of a state's case.

B. Recognition of the Grand Jury Inquiry as a Critical Stage

Chief Justice Burger's acknowledgement in Coleman that a grand jury inquiry is a "decidedly more 'critical' " stage of criminal procedure than an optional preliminary hearing designed to determine whether sufficient evidence exists to bring an accused before a grand jury should be adopted by the California Supreme Court. While the Chief Justice made the assertion in his dissent that the Constitution does not require the assistance of counsel at a preliminary hearing, Coleman remains operative and its application to only preliminary hearings contributes to the procedural disparity criticized by Justice Mosk. The Court's justification for applying the sixth amendment to the preliminary hearing is cogent evidence that it should be applied to a grand jury inquiry whose function is identical to that of most preliminary hearings—the determination of whether there is sufficient cause. If the California court eventually agrees to deem the grand jury inquiry a critical stage, the issue would become whether an accused should be afforded a post-indictment hearing or additional procedural guarantees during the grand jury proceeding. The latter provision would seem preferable. In the entire American criminal justice system there are only two institutions which require that adjudications be made by laymen: the petit and the grand juries.

92. 488 P.2d at 619-20.
93. In Uhlemann, the California Supreme Court was concerned with the magistrate's determination of the case on the merits and ruled that the power of a magistrate is limited to determining whether sufficient cause exists to hold defendant for trial. Since a final judgment on the merits may not be issued by a magistrate, the court held there was no bar to a subsequent prosecution. 9 Cal. 3d at 667-69, 511 P.2d at 610-13, 108 Cal. Rptr. at 659-61. It can be argued that the adoption by the California Supreme Court of the rule in Hope would not disturb the ruling in Uhlemann. Rather, it would affirm the rule that the magistrate's power is limited to deciding the issue of sufficient cause. But the magistrate's decision, not rendered on the merits, would be binding in subsequent attempts to find sufficient cause in the absence of additional evidence not produced at the earlier proceeding.
94. See note 70 supra.
95. 15 Cal. 3d at 262, 539 P.2d at 801, 124 Cal. Rptr. at 41.
96. See note 69 & accompanying text supra.
One sponsor of the proposed Grand Jury Reform Act of 1975 believes that it would be a mistake to minimize the role of the grand jury “at a time when popular participation in our political and legal institutions needs to be encouraged, not discouraged.” A grand jury proceeding with procedural safeguards—assistance of counsel within the grand jury room and the right to confront and cross-examine witnesses—would make a post-indictment hearing unnecessary and leave the final determination of the existence of probable cause with the grand jurors. There are strong indications, however, that the California Supreme Court is not anxious to consider these issues on constitutional grounds.

IV. CONCLUSION

Johnson provides an accused with a new and important measure of protection against prosecutorial excesses at the grand jury level of the criminal process. In bolstering the capacity of a grand jury to render a more objective and independent determination on the issue of sufficient cause, the decision partially responds to recent criticism that the grand jury serves at the pleasure of the prosecutor. The obligation now placed on a prosecutor to affirmatively produce exculpatory evidence in his possession narrows the wide gap which has developed between the right of a defendant to discover at trial favorable material evidence and the few, if any, rights of an individual who is the subject of an indicting grand jury proceeding. The court seemed determined to fashion relief, hesitated from reaching too far, and promulgated a reasonable rule by interpreting section 939.7 in a way which runs counter to the court's previous guidelines on statutory construction. Whether Johnson will start a trend in other states will depend on the

98. 121 CONG. REC. E-487 (1975) (remarks of Representative Conyers).
99. There may be instances, particularly in cases involving government corruption and organized crime, in which there is a compelling need for secrecy in order to protect the identity and security of witnesses. In such a situation, a prosecutor should be allowed to petition the trial court for an order to hold the grand jury proceeding ex parte with the understanding that a post-indictment hearing will follow in the event an indictment is returned.
100. In Fasanaro v. Superior Court, Civil No. 36843 (Cal. Sup. Ct., Oct. 30, 1975), the court was directly faced with petitioner's contention that the prosecutor's failure to disclose exculpatory evidence violated his right to due process. Counsel for Fasanaro attempted to have the court expand Johnson by framing his chief arguments in constitutional terms. See Petitioner's Reply Brief to Supplemental Opposition to Petition for Writ of Prohibition at 2-3, Fasanaro v. Superior Court, Civil No. 36843 (Cal. Sup. Ct., Oct. 30, 1975). The court repeated its avoidance of the constitutional issues and remanded Fasanaro to the court of appeal for consideration in light of Johnson. It is apparent that for the time being the court seems content with the ground broken in Johnson. See note 87 supra.
Casenotes

degree of prosecutorial excesses in those other jurisdictions and the extent to which tribunals desire to restrict such excesses by similarly interpreting their comparable statutory provisions.

The constitutional objections raised by Justice Mosk should be considered by the court and should form the basis for a subsequent ruling which would lessen the differences between information and indictment procedures. The court should limit forum shopping by requiring additional evidence in the event of a reprosecution and should recognize that, in light of the logic of Coleman, the grand jury deserves to be deemed a critical stage of the criminal process. Notwithstanding the court's avoidance of the constitutional issues in Johnson and Fasanaro, the presence of three justices who are concerned with those constitutional aspects suggests that additional protection for an accused can be expected from a jurisdiction which has greatly expanded an accused's rights throughout the stages of the criminal process.

Eugene I. Goldman

SECURITIES LAW—Section 16(b)—Concept of Beneficial Ownership Used to Broaden Insider Liability for Short-Swing Profits. Whiting v. Dow Chemical Co., 523 F.2d 680 (2d Cir. 1975).

Section 16(b) of the Securities Exchange Act imposes liability on an “insider” for profits gained through sales and purchases, or purchases and sales, of his company's securities within a 6-month period. In an effort to protect public investors from the use of nonpublic corporate information by certain statutorily defined insiders, section 16(b) recaptures the profit from any covered transaction without regard to whether or not the insider acted on nonpublic information. The United States Court of Appeals for the Second Circuit, in Whiting v. Dow Chemical Co., was faced with the question of

101. See note 65 supra.

2. The definition of an insider is included in section 16(a), 15 U.S.C. § 78p(a) (1970): “Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any [registered, nonexempted] equity security . . . or who is a director or an officer of the issuer of such security . . . .”
3. 523 F.2d 680 (2d Cir. 1975).
whether formally separate sales and purchases of company stock by an
insider and his wife should be aggregated so as to fall within section 16(b).
The court's decision that these transactions are within the statute has opened
a potentially broad new area of section 16(b) coverage.

Appellant Macauley Whiting was a director of Dow Chemical Co. His
wife, a granddaughter of the founder of the company, had considerable
holdings in Dow stock. The Whitings' assets were formally segregated,
although their individual accounts were managed by the same financial
advisors, and their general investment philosophy was formulated jointly.\(^4\) In
late 1973, Mrs. Whiting, with the knowledge and approval of her husband,
decided to increase the rate of sale of her Dow stock. In accord with this
decision she sold a total of 29,770 shares in September and November 1973
at an average price of $55 to $56 per share. One month later, in December
1973, Mr. Whiting exercised an option to purchase 21,420 shares at a price
of approximately $24 per share.\(^5\) The financing for Mr. Whiting's purchase
was obtained through an intrafamily loan from his wife with funds which she
had received from her recent sales of Dow stock.\(^6\) After becoming aware
that he might be liable for profits garnered from the matching sales and
purchase, Mr. Whiting sought a declaratory judgment from the district court
that he was not liable under section 16(b). Dow counterclaimed for the
profits and, after trial, the district court awarded judgment for Dow.\(^7\)

---

\(^4\) Id. at 682. There was considerable argument between the two parties concerning
the degree of control which Mr. Whiting exerted over his wife's investment policy. Dow
argued that over a 17-year period "Mr. Whiting ha[d] either himself selected, or ha[d]
exercised a controlling influence over the selection of" his wife's legal and financial
advisers, and "ha[d] exercised a controlling influence over the management
and disposition of his wife's Dow securities." Brief for Appellee at 11, Whiting v. Dow
Chem. Co., 523 F.2d 680 (2d Cir. 1975). Plaintiff argued that Mrs. Whiting maintained
her financial independence by employing her own financial advisers who were not
controlled by her husband. Post-Trial Memorandum for Plaintiff at 10, Whiting v. Dow
neither had nor wanted control over Mrs. Whiting's Dow holdings." Brief for Appellant
resolved this issue of control in the plaintiff's favor, finding that Mrs. Whiting was not
the "alter-ego" of her husband. See p. 667 infra.

\(^5\) 523 F.2d at 682. The "recoverable" profit resulting from the matching sale and
purchase was in excess of $200,000.

\(^6\) Id. The fact that Mr. Whiting purchased the stock with the proceeds from his
wife's recent sales of Dow stock was probably the most damaging aspect of their case.
The appeals court believed that the loan was the connecting link between the sales and
purchase which the appellant argued so strenuously were separate and unrelated transac-
tions. Compare id. at 688 with Brief for Appellant at 3-4, Whiting v. Dow Chem. Co.,
523 F.2d 680 (2d Cir. 1975).

district court held that although the transaction did not clearly fall within the literal
On appeal, the Second Circuit was particularly concerned with the facts as established by the district court. Among these was the fact that both of the Whitings were aware of, and had participated in, the decisions to execute the sales and purchase in question. In addition, it was clear that the income from Mrs. Whiting's stock was a significant factor in maintaining the family's lifestyle, since she provided the funds to cover numerous expenses which otherwise would have come from her husband's salary. The lower court had also found that Mrs. Whiting maintained her own financial records, that she did not mingle her assets with her husband's, and that "there is no evidence that he [Mr. Whiting] controls . . . even the general aspects of the management of her estate."

The issue which the appeals court faced in Whiting was whether Mr. Whiting had "realized profit" within the meaning of section 16(b) from the sales and purchase in question, so as to make him liable for the profit under the statute. The court held that since plaintiff was the "beneficial owner" of his wife's stock for section 16(b) purposes, he did realize profit from the sales and purchase and was liable to Dow for that amount.

I. Determining the Boundaries of Section 16(b)

Section 16(b) was included in the Securities Exchange Act of 1934 for the specific purpose of protecting the investing public from speculation by corporate insiders on the basis of information not available to the general public. The common law remedy for abuse of inside information required a showing of bad faith on the part of the insider. It was the difficulty of meeting this burden which inspired the congressional view that a ban on insider trading could only be effective if a showing of intent was not required as a necessary element. The result is that section 16(b) imposes liability

language of section 16(b), the statute should be interpreted to cover this case since the transaction at issue was susceptible to the kind of abuse which Congress sought to prevent in passing section 16(b). Id. at 1135-36.
8. 523 F.2d at 688.
9. The court found that Mrs. Whiting's income was used to pay for the children's education, the family's medical expenses, the maintenance of a vacation home, and the payment of real estate taxes on the family home. Id. at 682.
10. 386 F. Supp. at 1132.
11. 523 F.2d at 688-89.
12. See S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934). See generally S. Rep. No. 1455, 73d Cong., 2d Sess. 55-68 (1934), which relates specific examples of the kinds of speculative abuse at which section 16(b) was aimed.
for short-swing profits "irrespective of any intention" on the part of the insider to hold the securities longer than six months, and establishes a conclusive presumption that inside information affected any trading that falls within the boundaries of the section.

The provision for automatic liability has had a significant impact on interpretations of the language of section 16(b) by the courts. Some courts have inferred from the automatic liability provision that Congress intended that the statute be applied in an entirely "objective" fashion that is, if the transaction at issue fits within the literal terms of the statute, the profits may be recovered. Other cases have taken a more flexible approach to section 16(b) liability, particularly when the transaction involved is "unorthodox" or does not fall clearly within or without the statute. This

16. The leading case expressing the various aspects of the "objective" approach is Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965). The case involved a suit against a director of Heli-Coil who converted company debentures into common stock and then sold the stock within a 6-month period. The court held that the conversion of debentures to common stock was a "purchase" of common stock within the meaning of section 16(b), thus making the defendant liable for the profits arising from the subsequent sale. Id. at 167. The court based its holding on the theory that Congress intended the test of section 16(b) coverage to be "an entirely objective one" and did not desire that courts delve into the individual character of each transaction. Id. at 164-67. For other cases which have employed the objective approach, see Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir.), cert. denied, 332 U.S. 761 (1947); Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), cert. denied, 320 U.S. 751 (1943).
17. So-called unorthodox transactions have been those which could not easily be characterized as "purchases" or "sales" in a commercial sense and thus were not clearly covered by the literal terms of section 16(b). See Gadsby & Treadway, Recent Developments Under Section 16(b) of the Securities Exchange Act of 1934, 17 N.Y.L.F. 687, 688 (1971). These unorthodox transactions have repeatedly arisen in a number of specific situations. The first involves business mergers, and the question of whether the exchange of stock in the merged company for stock in the merging company is a "sale" of the former stock within the meaning of section 16(b). See, e.g., Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973); Newmark v. RKO Gen., Inc., 425 F.2d 348 (2d Cir.), cert. denied, 400 U.S. 854 (1970). A second common situation involves the question of whether the execution of an option contract to buy or sell stock constitutes a "purchase" or "sale" within the statute. See, e.g., Kern County Land Co. v. Occidental Petroleum Corp., supra; Bershad v. McDonough, 428 F.2d 693 (7th Cir. 1970), cert. denied, 400 U.S. 992 (1971). A third common situation involves the question of whether the conversion from preferred to common stock constitutes a "purchase" of common stock within the meaning of section 16(b). See, e.g., Petteys v. Butler, 367 F.2d 528 (8th Cir. 1966), cert. denied, 385 U.S. 1006 (1967); Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967); Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), cert. denied, 359 U.S. 927 (1959).
18. Borderline transactions other than those involving an interpretation of purchase
flexible, "pragmatic" approach requires an initial determination of whether the transaction at issue is of a type which affords the opportunity for the kind of abuse which Congress sought to prevent in passing section 16(b). This abuse is usually characterized as the realization of short-swing profits on the basis of inside information.\footnote{10} If the answer to this question is affirmative, liability for short-swing profits will be imposed if the transaction can fairly be covered by the statutory language.\footnote{20}

In two recent cases involving the question of section 16(b) coverage, the Supreme Court has used both tests. In \textit{Reliance Electric Co. v. Emerson Electric Co.}, the Court declined to consider the intent behind the transaction at issue or whether it might afford the opportunity for abuse of an insider's position.\footnote{21} Refusing to impose liability, the Court reasoned that the fact that the sales of stock had been specifically structured so as to avoid liability was irrelevant since the sale did not fall within the literal terms of the statute.\footnote{22} In a later case, \textit{Kern County Land Co. v. Occidental}

...
Petroleum Corp., the Court did look to the possibility for abuse in determining whether either an insider’s exchange of stock for that of an acquiring company pursuant to a merger agreement or the insider’s grant of an option to buy back the shares so acquired constituted a “sale” within the meaning of section 16(b). The Court held that on the basis of the involuntary nature of the exchange transaction and in the absence of any possibility for abuse in both transactions, neither constituted a “sale” within the statute, and the resulting profits were not recoverable.

The use of the pragmatic approach in Kern County was the culmination of a trend toward that approach in the courts. As a result of the increasing occurrence of transactions such as those in Kern County, which defy easy categorization under section 16(b), courts have been forced to adopt a more flexible approach to determining liability under that section. The pragmatic approach is a manifestation of that flexibility.

The principal concept which must be explored in order to understand the decision in Whiting is that of beneficial ownership. The term “beneficial owner” occurs in a number of contexts in section 16, but it is not specifically defined in that section. In two releases, the Securities and...
Exchange Commission (SEC) has attempted to define the term as it relates to securities held in the names of family members. The definition formulated by the SEC presumes that a person is the beneficial owner of securities held in the name of a family member when he receives "benefits [from the stock which are] substantially equivalent to ownership." Beneficial ownership traditionally has been of primary importance in the determination of which stocks must be reported under section 16(a). The SEC has distinguished between section 16(a) and section 16(b) in this context by stating that stocks which are reported under section 16(a) are not necessarily subject to section 16(b) liability.  

Prior to Whiting, the concept of beneficial ownership was used infrequently to bring a borderline transaction within the coverage of section 16(b). In Marquette Cement Manufacturing Co. v. Andreas, the argument was made that an insider realized profit from the short-swing transactions of a number of family trusts. The court held the defendant liable for the profits made by those trusts of which he was the beneficiary but not for those of which his wife was the beneficiary. The question of whether the insider might have benefited from profits accruing to the wife's trusts was answered in the negative, largely because the insider's wife had "recognizably different interests" from his.

In a second case involving the question of beneficial ownership, Blau v. Potter, the court simply assumed that if the insider were the beneficial owner of his wife's stocks he would be liable for short-swing profits obtained from their sale and purchase. This assumption was dicta, however, since, based on the facts of the case, the insider was not the beneficial owner of his wife's stock.


34. Id. at 967. The insider and his wife were in fact divorced at the time of the transaction in issue. The court felt that the "normal interest" of one family member in another member's financial security was not a sufficient basis on which to hold that the profits were "realized" by the insider. Id.


36. Id. ¶ 94,115, at 94,477.

37. Id. ¶ 94,115, at 94,478; see note 48 infra.
These cases, then, are of little aid in determining the degree to which the concept of beneficial ownership might be combined with a flexible or pragmatic interpretive approach to section 16(b) in order to expand the section's coverage. Prior to *Whiting*, the issue had not been directly addressed by the courts.\(^{38}\) The Second Circuit's analysis is thus helpful in determining the potential scope of the broadened liability under section 16(b).

### II. THE EXPANSION OF SECTION 16(b)

In *Whiting*, the court was initially faced with the fact that Dow was alleging liability under section 16(b) despite the trial court's finding that Mr. Whiting did not exercise exclusive control over his wife's stock transaction.\(^{39}\) Although Whiting argued that liability was negated upon this finding alone,\(^{40}\) the court refused to be so confined.\(^{41}\) By insisting on looking behind what appeared at first glance to be separate transactions of the insider and his wife, the court implicitly adopted the pragmatic approach to section 16(b) liability.\(^{42}\) Had the court adopted the objective approach, which requires that section 16(b) liability arises only when the transaction fits the literal terms of the statute,\(^{43}\) the court could have decided the case on a narrower ground. Since the objective approach eschews an analysis of the individual characteristics of the transaction at issue,\(^{44}\) the *Whiting* court, had it adopted that approach, could have refused to consider the possibilities for abuse of inside information which the case presented. The court could have simply held that the insider did not "realize" profit within the meaning of section 16(b) because the profit from the sale of stock was not legally his.\(^{45}\) The court, however, did consider the character of the disputed

\(^{38}\) See 523 F.2d at 681, 684.

\(^{39}\) See text accompanying note 10 supra.

\(^{40}\) See Brief for Appellant at 10-20, Whiting v. Dow Chem. Co., 523 F.2d 680 (2d Cir. 1975), in which it was argued that no prior case had attributed the transactions of one person to another (the insider) without a showing that the insider controlled the transaction. But see Brief for Appellee at 27-29, Whiting v. Dow Chem. Co., supra.

\(^{41}\) The court insisted on viewing the totality of facts to determine "whether the other indicia of [the Whitings'] relationship [were] sufficient to bring the transaction under the rule of Section 16(b) . . . ." 523 F.2d at 685.

\(^{42}\) Cf. text accompanying note 46 infra.

\(^{43}\) See generally p. 668 & note 16 supra.

\(^{44}\) See, e.g., Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418 (1972), in which the Court refused to consider the possibility that the transactions at issue were specifically structured so as to avoid section 16(b) liability. Id. at 425. The fact that the transaction was outside the literal terms of the statute was sufficient to negate liability. Id. at 426-27.

\(^{45}\) But see Brief for Appellee at 229, Whiting v. Dow Chem. Co., 523 F.2d 680
transactions, concluding that "to allow immunity here would open the door to patent abuse which Congress sought to prevent ..."46 The court based this conclusion on the facts that Mr. Whiting obtained substantial benefits from, and exercised significant control over, his wife's stock, making him a "beneficial owner" of that stock.47

The court's decision seems consonant with prior cases discussing the issue.48 When an insider is shown to have received significant monetary benefits from his spouse's stock and when he appears to have substantial influence over the disposition of that stock, he should be held to be a beneficial owner.49 A person has been deemed not to be a beneficial owner, however, when his control over the stock appears minimal or when he enjoys no substantial benefits from the proceeds of the stock.50

In cases addressing the somewhat similar issue of whether a company can be liable under section 16(b) because it has "deputized" an insider of another company, the considerations of the courts have also been ones of

(2d Cir. 1975), in which Dow argued that the statutory language, "profit realized by him from any purchase and sale," even read literally covers short-swing transactions involving securities from which the insider receives benefits substantially equivalent to ownership. Dow thus argued that the court could impose section 16(b) liability even under the objective approach.

46. 523 F.2d at 689.
47. Id. at 688-89. The court specifically held that in order to be a beneficial owner, one's control over the stock need not be exclusive, at least when the transactions involving the stock were part of a common plan jointly managed by the insider and his spouse. Id.
48. See Blau v. Potter, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,115 (S.D.N.Y.) (insider was found not to be the beneficial owner of his wife's shares because, among other things, she maintained her own brokerage accounts and kept her funds segregated from his; the purchases in question were made entirely with her own money, without any consultation with her husband; and none of the proceeds of the stock went to pay household expenses); Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962, 967 (S.D.N.Y. 1965) (insider held not to be the beneficial owner of stock held in trust for spouse because the trust was "bona fide and not revocable" by the insider and because he and his wife had "recognizably different interests," id. at 967).
49. See Feldman & Teberg, supra note 31, at 1065. The authors suggest that beneficial ownership should be found whenever a person in fact enjoys benefits from another's stock. They suggest that it is not the enforceable right to the benefits which beneficial ownership implies, but the actual enjoyment of such benefits. That the Whiting court seems to have accepted this interpretation is implicit in its statement that the case expands the concept of beneficial ownership beyond what it connotes in the law of trusts. See 523 F.2d at 688. In its analogy to the law of trusts, the court seemed to be referring to a concept more commonly referred to as beneficial interest, that is, a "benefit, or advantage resulting from a contract, or the ownership of an estate as distinct from the legal ownership or control." BLACK'S LAW DICTIONARY 199 (4th ed. 1968). The term "beneficial owner" as used in Whiting connotes a more attenuated interest than that which is traditionally meant by a beneficial interest. See also SEC Securities Act Release No. 7793 (Jan. 19, 1966), 3 CCH FED. SEC. L. REP. ¶ 26,031 at 19,057-3.
50. See note 48 supra.
control and influence. When the insider exercised control over his principal's investments sufficient to make it possible to profit from his insider position, the company has been held liable under section 16(b).\(^5\) When it was clear that the insider was not consulted concerning his principal's investments, section 16(b) liability has not been imposed.\(^5\) In all of these cases, the degree of participation by the insider in any disposition of the stock and the degree to which he benefits from the stock proceeds are the crucial issues in determining section 16(b) liability.

Benefit and control are also stated to be the important factors in the SEC's definition of beneficial ownership;\(^5\) the Whiting court relied heavily on that definition in its analysis of the case.\(^5\) After an extensive analysis to determine that Mr. Whiting was a beneficial owner of his wife's stock,\(^5\) the court concluded that the determination was sufficient, in itself, to hold that the profit from the sales of the stock was "realized by him" within the meaning of section 16(b).\(^5\)

The reliance on the concept of beneficial ownership in Whiting can be criticized, however, on the ground that the concept, as defined by the SEC, has traditionally been of primary importance in determining reporting requirements under section 16(a).\(^5\) Its definition and development as a concept have been influenced by the policy underlying that section, that is, the requirement of comprehensive reporting of stock ownership.\(^5\) The policy of broad disclosure is served by an expansive interpretation of the

\(^{51}\) See cases cited note 18 supra.

\(^{52}\) See Feder v. Martin Marietta Corp., 406 F.2d 260, 263 (2d Cir. 1969), cert. denied, 396 U.S. 1036 (1970) (deputy had ultimate responsibility for all Martin Marietta's investments and had specifically approved the transactions in issue).

\(^{53}\) See Blau v. Lehman, 286 F.2d 786, 788-89 (2d Cir. 1960), aff'd, 368 U.S. 403 (1962) (alleged deputy had no responsibility for Lehman's investments and had not been consulted concerning the specific transaction at issue).

\(^{54}\) See note 31 & accompanying text supra. The SEC has suggested that one of the "benefits" which a beneficial owner derives is the ability to control "the purchase, sale, or voting of such securities." SEC Securities Act Release No. 7793 (Jan. 19, 1966), 3 CCH FED. SEC. L. REP. ¶ 26,031 at 19,057-3.

\(^{55}\) See 523 F.2d at 686-88.

\(^{56}\) Id. at 687-89.

\(^{57}\) "The whole profit is 'his' profit, 'realized by him' because the shares are 'his' by the statutory 'beneficial owner' concept as applied . . . ." 523 F.2d at 689.

\(^{58}\) See p. 671 supra.

\(^{59}\) Cf. Feldman & Teberg, supra note 31, at 1060-66. The authors note that section 16(a) was intended to curtail stock fraud and manipulation by exposing many stock transactions to public view. Id. at 1096. The theory was that such transactions thrived on secrecy and would be substantially discontinued if publicized. See generally Cook & Feldman, Insider Trading Under the Securities Exchange Act, 66 HARV. L. REV. 385, 386 (1953).
statutory term "beneficial owner," so as to make its coverage as extensive as possible.

The difference in policy between sections 16(a) and 16(b) seems apparent. While section 16(a) was intended to be a broad, comprehensive provision, section 16(b) was directed at an isolated, narrowly defined offense which Congress judged to be unfair. Insider trading was not banned by a broad sweep, but was to be discouraged only in the narrow context in which Congress believed it to be most offensive. The refusal of the SEC to make the section 16(a) reporting requirements and section 16(b) liability coextensive is rationally based on the differing policies of the two provisions. The use by the Whiting court of the concept of beneficial ownership does not give full recognition to this difference.

III. Conclusion

By combining the concept of beneficial ownership with a flexible, pragmatic approach to the language of section 16(b), the Second Circuit in Whiting expanded the coverage of that section. The real significance of the case lies in two aspects of the court's analysis. The first is the court's rejection of the theory that an insider must have exclusive control over the transaction at issue in order to be held liable for profits under section 16(b). The court believed it was sufficient to show "joint control," at least when the parties involved were husband and wife.

The second important aspect of the case is the court's use of the concept of beneficial ownership as developed under section 16(a) to impose liability under section 16(b). The concept was used to link the insider with stock to which he did not hold legal title. The use of the concept of beneficial ownership in this fashion expands its importance beyond what it was originally intended to be, that is, an additional reporting requirement under section 16(a). It also may lend support to other attempts to establish section 16(b) liability when the insider does not hold legal title to the stocks involved.

---

60. Courts and commentators have repeatedly stressed that in passing section 16(b), Congress intended to discourage only that insider trading which produced profit from matching sales and purchases occurring within six months of each other. See Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 422 (1972); Lewis v. Varnes, 505 F.2d 785, 787-88 (2d Cir. 1974); 2 L. Loss, SECURITIES REGULATION 1040-44 (2d ed. 1961).
61. 523 F.2d at 688-89.
62. Id. at 688.
63. The theory of deputization, for example, may be indirectly strengthened through the reasoning of Whiting. See generally note 18 supra.
It is clear from previous cases involving section 16(b) and from Whiting that the nature of the transaction at issue is crucial.\(^6^4\) The characteristics of the transaction determine whether it is clearly within or without the statute. It is only when the transaction does not fit easily into one or the other area that the courts must be flexible in interpreting the statutory language. By the use of this flexible approach and the concept of beneficial ownership in Whiting, the court has increased the uncertainty and unpredictability of section 16(b) coverage.\(^6^5\)

Stephen R. Lohman

64. The importance of the particular facts in Whiting can be appreciated by recognizing the careful and extensive consideration which the court gave to the facts as established by the district court. See 523 F.2d at 682-84. A comparison of cases which fall clearly outside the statute and those which are “borderline” illustrates the greater importance placed on the characteristics of the transaction in the latter cases. Compare Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418 (1972) with Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973).

65. The Whiting court recognized the irony of this need for flexibility and the importance of the particular characteristics of the transaction at issue in applying a statute which was intended by Congress to be “simple and arbitrary in its application . . . .” 523 F.2d at 687. Other cases and commentators have similarly criticized the pragmatic approach on the ground that it makes application of the statute unpredictable and uncertain. See Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 612 (1973) (Douglas, Brennan & White, JJ., dissenting); Petteys v. Butler, 367 F.2d 528, 538 (8th Cir. 1966) (Blackmun, J., dissenting); Bateman, supra note 27, at 773; Deitz, supra note 26, at 37-38.